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BOOK REVIEW

Jean-Charles Rochet: Why Are there so Many Banking Crises?

Princeton University Press, 2008

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Recent bank failures highlight the topicality and importance of the book. Jean-Charles Rochet, a leading expert in the field of banking, presents ten of his articles published in scientific journals between 1996 and 2004. The book provides an excellent introduction to the theory of banking regulation. The author analyzes the mechanisms of banking regulation and his suggestions to improve the existing system. A drawback of the book is that it does not investigate how information asymmetries in the banking system can be reduced. However, the author acknowledges their role for distressed banks.

The book is organized in an introduction and four parts. The first part, which shares the book's title, introduces the sources of bank fragility, the fractional reserve system and the resulting risk of bank runs. The three regulatory channels on how to stabilize the system are then introduced and are the topics of the subsequent parts. These are: *The Lender of Last Resort* (Part Two) and *Solvency Regulations* (Part Four). In line with the academic literature, the author suggests using financial markets to assess and ensure the solvency of banks. In particular, the use of private ratings and the idea to force banks to issue subordinated debt are discussed. This is the topic of the Third Part of the book, *Prudential Regulation and the Management of Systemic Risk*.

The task of *The Lender of Last Resort* (LLR) is to lend to solvent but illiquid banks, for example in case of a mismatch of the assets' and liabilities' maturity. In the first article of this section, the author provides a rationale for the existence of an LLR, even when there is solvency and liquidity regulation and a developed interbank lending market. This is because investors in this market can fail to coordinate, and necessary solvency and liquidity requirements would be too costly. The LLR, however, should only be one part of a regulatory system and has to be complemented

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with provisions for the prompt and orderly resolution of the crisis. If there is an LLR in the market, it faces two main problems: first, it is difficult to distinguish between illiquid and insolvent banks, and second, moral hazard and gambling for resurrection can affect the behavior of distressed banks. These two problems are analyzed in the second presented article and policy implications and mechanisms for design of the LLR and its interplay with interbank markets and supervisors are derived.

The four articles in the next part deal with *Prudential Regulation and the Management of Systemic Risk*. While the interest rates' interbank lending market should impose the market discipline, the existence of an LLR can lead to a failure of market discipline because intervention could be anticipated. In the first article, the authors show that this is indeed the case. However, they find that independent banking supervisors are more important than market information for regulatory purposes. The importance of interbank payment systems for systematic risk and protecting the LLR against undesired intervention is shown in the next article. The author shows how peer-monitoring can work and how interbank loans should be structured for it to work. In the next article the design of the interbank payment system is studied. Such a system should be tractable, traceable, and induce low systematic risk. It should also be smoothly running, be affordable, and generate reliable information on bank solvency. Net and gross payment systems as well as mixed ones are able to fulfill these requirements depending on who pays in the case of failure, who monitors, and who has the power to intervene. It is particularly important to account for the fact that illiquidity and insolvency cannot be separated. The authors suggest improving regulatory systems through modifications of debit caps and overdraft facilities, and by centralizing all credit lines and transactions in a gross system for monitoring purposes. The resiliency of the banking system in general is investigated in the last article in this Part. It is shown that the interbank market leads to a minimization of total system required liquidity. This benefit comes at a cost: it can come to excessive liquidation of investments if there are large unexpected withdrawals and insolvent banks are subsidized through the system. A set of policy implications is derived. Interestingly, the authors find the interbank payment system structure to be determined by the structure of the interbank lending market, because of incomplete information.

Solvency Regulations is the topic of the last Part. First, capital regulations similar to Basel I are studied in both complete and incomplete markets. The author shows that this regulation can actually lead to increased risk taking by banks and not to a reduction of the chance of failure. Market based risk weights and actuarial premiums for deposit insurance are suggested to fix this problem. Basel II is studied in the next chapter. In a formal model, the authors investigate the interaction between capital regulation, supervisory review, and market discipline. Direct market discipline through the issuance of subordinated debt is shown to provide meaningful information about a bank's solvency. Moreover, it can be an important complement for supervisory action. Thus, keeping close relationship with banks and market discipline should be in the focus of supervisors and not the complexification of risk-based capital requirements. The final chapter of this Part analyzes the three pillars of Basel II. In a simple dynamic model, the previous chapters' findings are refined: political interference and erratic market prices in periods of crisis can affect the stability of the system negatively. Thus, the supervisory system should be reformed to guarantee independence and prudential action in future crises.

Summarizing, I can recommend the book to anyone interested in a formal, academic approach to banking regulation. The concise conclusions of the individual articles provide valuable ideas for changes in banking regulation.

Jean-Charles Rochet is a Professor of Mathematics and Economics at the University of Toulouse and a visiting professor at the London School of Economics and Political Science. His books include (with Xavier Freixas) *Microeconomics of Banking* and (with Guillaume Plantin) *When Insurers Go Bust* (Princeton).